Statement of Pamela F. Olson
To the
Budget Committee
United States House of Representatives
Problems Facing the U.S. Tax System

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Chairman Nussle, Ranking Member Spratt, and distinguished members of the Committee, I appreciate the opportunity to appear this morning to discuss current problems facing our tax system. I am here today at the request of the Committee. I am currently a partner in the law firm, Skadden, Arps, Slate, Meagher & Flom, LLP, but I am not appearing on behalf of any client or other organization, and the views I offer are solely my own.

I. Introduction

The ideal tax system would raise the revenues to fund the operations of the government with the least adverse impact on the economy – that is, it would be neutral, transparent, stable, and certain. Our tax system falls short of the ideal system in several respects, and it is those shortcomings my testimony addresses. Before turning to that topic, however, it would be useful to focus for a moment on the budgetary impact of the increasing tendency to "spend" through the tax code.[*]

II. Spending through the Code

In recent years, the Internal Revenue Code has been amended repeatedly with provisions intended to encourage, reward, or reduce the cost of certain favored activities through exclusions, deductions, exemptions, special rates, and credits.[†] While the goals of some of the provisions may be admirable, they represent uncapped, unverified, and, in large measure, unverifiable indirect spending programs. They are uncapped because any taxpayer satisfying the applicable requirements may claim the resulting tax reduction or outlay. While targeting the benefits of the provisions to particular classes of taxpayers may hold down the budgetary impact, it does so at the expense of simplicity, a point worthy of further discussion.

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[*] The Treasury Department and the Joint Committee on Taxation each prepare an annual tax expenditure analysis, which is far broader in concept than the issues described below. The Treasury Department has devoted considerable effort in recent years to revising its tax expenditure analysis, some of which is described in the President's two most recent Budgets, to address inconsistencies and limitations of the analysis.

[†] What appeared to be an effort a few years back to "put a tax credit in every pot" led a Treasury Department economist to design the "tax credit for the taxpayer who didn't get a credit" in an effort to stave off further proposals.

They are unverified because taxpayers need not establish to the Internal Revenue Service their eligibility for the tax reduction or outlay before claiming it on their tax returns. They are largely unverifiable because neither the Treasury Department nor the Congress has been able to devise mechanisms that would permit the Internal Revenue Service efficiently and effectively to determine taxpayers' eligibility for many of the special provisions.

The inability to verify presents another serious issue: We cannot assess the efficacy of the expenditures in achieving the desired goals.

As the late former Treasury Secretary William Simon observed, "The United States should have a tax system which looks like someone designed it on purpose." No tax system ever devised has included so many things unrelated to tax collection. While one or two exceptions might be reasonable, the weight of all the exceptions puts at risk the basic goals of the tax system.

Spending through the tax code presents particular challenges to our ability to make accurate budgetary projections. It also affects economic growth and deprives the tax system of the neutrality, transparency, and certainty that would make for a better system, points to which I will now turn.

III. Minimizing the Tax System's Adverse Impact on the Economy

By removing resources from the private sector, the tax system slows the growth of the private sector of the economy. Minimizing the effect on the economy requires a system that minimizes its impact on decisions to work, save, and invest.

We can best foster economic growth with low rates, a broad tax base (*i.e.*, few exceptions equally applied), eliminating barriers to deploying and redeploying capital and labor, and a stable system. The amounts spent through the tax code (discussed previously) have narrowed the tax base. The myriad sunsets of current law are the opposite of the stability that allows taxpayers to plan their affairs.

It is important to have a system that is as uncomplicated as possible, a standard the current tax code fails miserably. Resources spent complying with the tax laws, which the Internal Revenue Service estimates for individuals alone total between $70 billion and $95 billion annually, are resources unavailable for more productive endeavors and are a drag on the economy.

The tax code's adverse effect on economic growth deserves Congressional attention.

IV. Neutrality

The tax system should apply on a neutral basis, that is, without discriminatory treatment. Investment decisions made on a basis other than maximizing pre-tax returns reduce national income to the detriment of all. Consequently, we should avoid rules that discriminate, thus biasing investment decisions. The best rules are rules that apply equally, without regard to industry, activity, type of entity, or form of investment. The Internal Revenue Code fails the neutrality principle on multiple scores.

V. Transparency

Transparency in a tax system has been described as certainty about what the rules are, how they will be applied, and that they will be applied fairly.* Transparency matters because it gives taxpayers confidence in the system. A system that is too complex loses transparency because of the difficulty of administering and complying with it. That, in turn, will erode confidence in the system and voluntary compliance. It goes without saying that reduced compliance means higher tax rates for compliant taxpayers.

The U.S. tax system is nothing short of opaque, that is, the opposite of the transparent system we should be seeking. It is impossible for any one person to understand all of the tax code's provisions, and the Internal Revenue Service cannot assure compliance or consistent application. Using income for our tax base ensures some complexity because income is inherently difficult to measure. However, we have exacerbated the problem with special rules that increase the disparities between taxable income and conventional determinations of income, such as financial statement income.

Although reliable information on compliance levels is hard to come by, it is my view that the growing complexity of the system has reduced compliance because many taxpayers simply throw up their hands in despair. The multitude of special provisions leaves taxpayers uncertain whether they have correctly claimed the allowable tax benefits, worrying they have missed some hidden provision, and wondering whether they paid more than their fair share. Perhaps even more important is that complexity creates shadows concealing those inclined to avoid their responsibilities.

In short, the opacity of the current system is a danger to our self-assessment system. Although the decline of the tax system on account of complexity has been predicted for decades, I believe that we are at a critical juncture. If we do not begin soon with significant steps to simplify the tax laws, I believe the system may collapse of its own weight.

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* A transparent system is the opposite of one in which the taxpayer negotiates his tax liability.

VI. Certainty

Decision-making can be difficult. Decisions involve expectations about the future but the future is uncertain. The greater the uncertainties are, the greater the risk is. The greater the risk is, the greater the premium required by the decision-maker. We can reduce decision-makers' risk premiums by giving them greater certainty about the future. At a minimum, we should not add to the risk premium attached by the decision-maker with provisions that go in and out of the tax code like yoyos. A system that is stable will reduce the risk premium and result in more productive decisions. I would urge you to go to work now to create a tax system that is not subject to annual revision.

VII. Particulars

I want to note for the Committee three particular budget issues.

The first relates to the efficacy of spending through the tax code. In order to deliver the benefits intended by the various spending provisions added to the tax code, the taxpayer must be aware of the benefits and capable of claiming them, and the Internal Revenue Service must be capable of administering them. The complexity of the tax code coupled with the educational level of many of the individuals to whom benefits are targeted makes the tax code a poor delivery mechanism for many intended benefits. The fact that eligibility is determined after the benefits are claimed adds an unhealthy uncertainty about whether an outlay will have to be repaid or additional taxes will be due at some point down the road.

Benefits delivered through the tax code are oftentimes highly particularized, requiring the Internal Revenue Service to make determinations about eligibility that it is without the expertise to make. Consider, for example, the expertise required to administer provisions in the tax laws relating to the environment, conservation, or energy. The resources required to administer such provisions appropriately are significant and detract from the Internal Revenue Service carrying out its primary tax collection function.

The second issue relates to projecting corporate receipts. The fact that corporate receipts have declined as a percentage of all receipts has received considerable attention of late. The decline may be traced to a number of factors:

- The growth of pass-through entities such as partnerships that has shrunk the corporate sector's share of gross receipts.
- Expensing of stock options.
- Increased use of indebtedness as a more tax efficient capital structure.
- A decline in corporate profitability.

Over time, however, corporate receipts have proved difficult to project and a volatile source of revenue. Receipts' trending down with an economic downturn is desirable because of the countercyclical effect, but it may be advisable to consider whether there is a base that would produce more predictable results than our current corporate income tax base does. Removing disparities between financial statement and taxable income might reduce some volatility. An entirely different base, such as business activities, might be considered as well.

Finally, our current savings rate is abysmal. It seems clear that the complexity of the savings provisions in the tax code prevents many taxpayers from taking advantage of those opportunities. Some complexity stems from the best of intentions: the desire to provide as many options as possible. As behavioral economists have demonstrated, however, having too may options can actually reduce the take up rate.[*] Taxpayers spend too much time trying to understand their options under the tax rules. It would be better if they put that time into making wise investment decisions. If we want people to get off the spending couch and into the savings gym, we need to make it easier for them to do so.

Although our tax system is sometimes said to be a hybrid of income and consumption taxes, it favors spending over saving except to the extent taxpayers can avail themselves of the complicated and illiquid savings provisions in the tax law. Over time, for example, two families who are identical except that one saves diligently will bear different tax burdens. The family that saves will see its income tax burden increase relative to the burden of the taxpayer who spent. In other words, virtue carries a cost, not a reward. Although current budget shortfalls dominate many discussions, the long-term shortfall stemming from unchecked Social Security and Medicare spending is a far more serious problem. The problem can be eased by increasing our savings rate. That means creating a tax code that encourages, not penalizes, those who save.

Thank you for inviting me to testify today. I would be happy to answer any questions.

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[*] In an upscale grocery store experiment, researchers set up a jam-tasting booth, first with six jars of jam from which shoppers could choose, and then with 24 jars of jam. When the shoppers had only six jars from which to choose, 40 percent tasted and 30 percent made a purchase. When the number was increased to 24, the percentage tasting increased to 60 percent, but the number buying dropped to three percent. More choices are not always better.